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Villa, Seppo

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At the Crossroads of Company and Insolvency Law

By Seppo Villa, Professor, LL.D. & Matti Engelberg, Founding Partner, LL.D.[1]

The article discusses one of the most fundamental aspects of corporate law, namely the intersection between company law and insolvency law, with specific regard to the recent EU Directive on Preventive Restructuring (EU 2019/1023, the 'Restructuring Directive' or 'Directive')[2]. It notes the forthcoming implementation of the Directive in the EU Member States. The key options for implementation of the Directive available to European legislators are introduced, including an option based on company law which, according to the recent LL.D.-dissertation of the co-author, would provide more tools for restructurings than are available under the frameworks based on insolvency law. This would create efficient mechanisms in particular for the preventive restructuring of solvent companies, but also for the completion of a friendly takeover of a publicly-listed company through a scheme of arrangement under company law. The scheme of arrangement mechanism has also been included in the recently published European Model Company Act.

1. The New Approach of the Restructuring Directive

The aforementioned Restructuring Directive came into force in July 2019. Each Member State now has a period of two years (extendable up to three years) in which to implement the Directive. The Directive, particularly in the modified form in which it was finally enacted, contains important features for legislators to consider. The key issues relate to the crossover of company law and insolvency law in the Member States, noting the impact on the position of shareholders in restructuring processes.

This article discusses the key provisions of the Directive relating to the treatment of shareholders in restructurings and outlines options for implementing the principles for preventive restructuring in the Directive through a company law scheme of arrangement mechanism.

For the first topic, the final form of the Directive introduces, even as a principal option, a new *relative priority* rule for restructuring proceedings. In recent legal writing, the merits of the *relative priority* rule compared to the *absolute priority* rule have been heavily debated. However, the debate does not, perhaps, adequately address the practical requirements of a restructuring

1 LL.D. Seppo Villa is Professor of Commercial Law (specializing Corporate Law) at the University of Helsinki and Adjunct Professor in several other Universities in Finland. He has published numerous books relating to company law and financial law. Prior his academic work he has over ten years' banking practice.
Matti Engelberg has recently defended his LL.D. at the University of Helsinki with over 30 years' practical experience in the field of capital markets and financial law. He is former partner of a leading Nordic law firm and currently founding partner of a boutique finance law consulting firm.

2 Directive of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 ('Restructuring Directive') OJ [2019] L 172/18

process. Flexibility for the courts and restructuring professionals to give incentives to each class of stakeholders in a restructuring scenario is a key driver for the new rule. A reference to this discussion is made in chapter 5 below.

The recitals to the Directive outline that a restructuring should enable debtors in financial difficulties to continue their business, in whole or in part, by changing the composition, conditions or structure of their assets and their liabilities or any other part of their capital structure – including by sales of assets or parts of the business or, where so provided under national law, the business as a whole – as well as by carrying out operational changes. Unless otherwise provided for specifically by national law, operational changes, such as the termination or amendment of contracts or the sale or other disposal of assets, should comply with the general requirements under national law for such measures, in particular civil law and labour law rules. Any debt-to-equity swaps should also comply with safeguards in national law. Preventive restructuring frameworks should, above all, enable debtors to restructure effectively at an early stage and to avoid insolvency, thus limiting the unnecessary liquidation of viable enterprises. Those frameworks should help to prevent job losses and the loss of know-how and skills, and maximise the total value to creditors – in comparison to what they would receive in the event of the liquidation of the enterprise's assets or in the event of the next-best-alternative scenario in the absence of a plan – as well as to owners and the economy as a whole.[3]

Company law is referred to in many sections of the Directive. According to the Directive's recitals, while a company's shareholders' or other equity holders' legitimate interests should be protected, Member States should ensure that they cannot unreasonably prevent the adoption of restructuring plans that would bring the debtor back to viability. Member States should be able to use different means to achieve that goal, for example by not giving equity holders the right to vote on a restructuring plan and by not making the adoption of a restructuring plan conditional on the agreement of equity holders that, upon a valuation of the enterprise, would not receive any payment or other consideration if the normal ranking of liquidation priorities were applied. However, where equity holders have the right to vote on a restructuring plan, a judicial or administrative authority should be able to confirm the plan by applying the rules on cross-class cram down notwithstanding the dissent of one or more classes of equity holders. The Member States that exclude equity holders from voting should not be required to apply the absolute priority rule in the relationship between creditors and equity holders. Another possible means of ensuring that equity holders do not unreasonably prevent the adoption of restructuring plans would be to ensure that restructuring measures that directly affect equity holders' rights, and that need to be approved by a general meeting of shareholders under company law, are not subject to any unreasonably high majority requirements and that equity holders have no competence in terms of restructuring measures that do not directly affect their rights.[4]

The recitals of the Directive further emphasise that the effectiveness of the adoption and implementation of the restructuring plan should not be jeopardised by company law. Therefore, Member States should be able to derogate from the requirements laid down in the directive (EU) 2017/1132 of the European Parliament and of the Council concerning the obligations to convene a general meeting and to offer shares on a pre-emptive basis to existing shareholders, to the extent and for the period necessary to ensure that shareholders do not frustrate restructuring efforts by abusing their rights under that directive.[5]

3 Restructuring Directive, recital 2

4 Restructuring Directive, recital 57

5 Restructuring Directive, recital 96

For example, Member States might need to derogate from the obligation to convene a general meeting of shareholders or from certain time periods in cases where urgent action is needed by the management to safeguard the assets of the company, for instance through requesting a stay of individual enforcement actions and when there is a serious and sudden loss of subscribed capital and a likelihood of insolvency. Derogations from company law might also be required when the restructuring plan provides for the emission of new shares which could be offered with priority to creditors as debt-for-equity swaps, or for the reduction of the amount of subscribed capital in the event of a transfer of parts of the undertaking. Such derogations should be limited in time to the extent that Member States consider such derogations necessary for the establishment of a preventive restructuring framework.[6] The Restructuring Directive notes that directive (EU) 2017/1132 should therefore be amended accordingly.

2. At the crossroads of company and insolvency law – Why and How?

As outlined above, this article discusses the intersection between company and insolvency law in the context of the Restructuring Directive on the one hand, and the potential usage of modern company law frameworks for restructuring on the other.

The Restructuring Directive, as a starting point, refers to a test of a likelihood of insolvency. However, what is meant by 'likelihood' is not further specified in the Directive. As there always is 'a' likelihood of insolvency, however small, this is unfortunate. Every company has a likelihood of insolvency – though for some companies such a likelihood may be greater than for others.[7]

However, the final version of the Directive clarifies that Member States should be able to maintain, or introduce into their respective legal systems, preventive restructuring frameworks other than those provided for in the Directive. Hence it would be fully legitimate for a legislator to address preventive restructuring with a company law framework as opposed to an insolvency law regime, as is the current status in English and Irish Law.

Any test that requires a company to have 'a likelihood of insolvency' or to be somewhere close to insolvency does not seem suitable as a requirement for an arrangement or a compromise, and would be difficult for a court to determine. The appropriate test, in such a scenario, should work from the opposite angle, as is currently the case under English law. One should consider (i) whether any need for a compromise and/or an arrangement exists, and if so, (ii) whether a proposal made by the company, supported by a clear majority of each class whose rights are proposed to be altered, is fair and justified.

When considering the legal tools for preventive restructurings that are closer to those customarily available in insolvency proceedings, including, for instance, a stay against any creditor claims, one may see a further need for such 'a likelihood of insolvency' test as a means of avoiding abuse of the procedures. Such a distinction has also been presented in a study conducted by leading Insolvency Law professionals for the European Law Institute (the 'ELI Study').[8] Only the frameworks referred to in the ELI Study as 'restructuring proceedings' require the debtor to show 'severe financial difficulties' to justify access to restructuring tools. Recommendation 1.25 of the ELI Study notes that pro-

6 *Ibid*.
7 Horst Eidenmüller, Contracting for a European Insolvency Regime, European Business Law Review (2017), 18:279

8 European Law Institute, Rescue of Business in Insolvency Law, 6.9.2017 available at: <https://www.europeanlawinstitute.eu/about-the-eli/bodies/general-assembly/default-title/rescue-of-businessand-insolvency-law/>

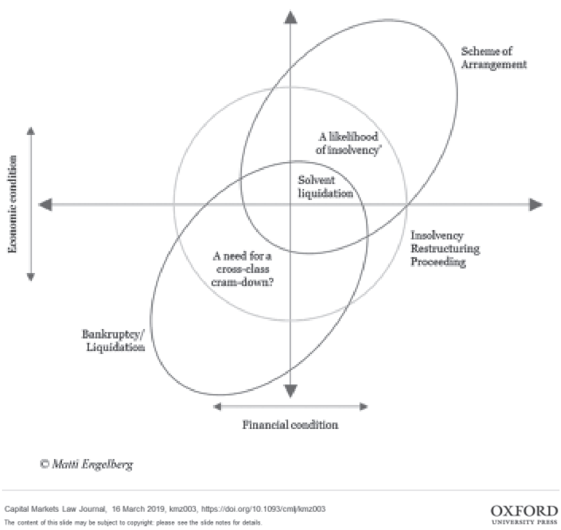
ceedings with a view to a 'work-out' should not require a specific access test referring to the situation of the debtor's business. Instead, the court should only require the debtor to submit a work-out agreement with sufficient creditor support according to the stipulated majority requirements. When considering options for a new *preventive* restructuring regime, a jurisdiction that already has a developed insolvency law framework for restructuring may indeed find it appropriate to analyse the benefits of developing a separate regime for the 'preventive' restructuring.

When considering the optimal preventive legal restructuring framework for Member States, the English company law scheme of arrangement, as well as providing a well-functioning example, could serve, *de minimis*, as a useful benchmark for legislators, at the same time aiding the further development of existing collective restructuring regimes, in accordance with the guidelines of the Directive.

Importantly, when a legal framework for effective restructuring is either missing or does not function effectively, small minority holders of financial instruments gain disproportionate power and can cause trouble to all stakeholders of a company. Such behaviour is customarily referred to as usage (or abuse) of hold-out positions in connection with any compromise or arrangement which calls for unanimous consent (for example, because the law or the terms of the instrument do not provide otherwise).

Figure 1 illustrates a hypothetical showing the matrix of the financial and economic condition of a company and the related needs for preventive and restructuring legal frameworks for the company and its stakeholders.[9] The figure is for illustrative purposes only and aims to demonstrate the variable situations, depending on the financial and economic condition of a company, where the need for one or more legal frameworks to protect the company and/or its stakeholders may arise. It is important to note that a scheme of arrangement framework is available for a company and its stakeholders any time there is a need for a compromise or arrangement with the company and its stakeholders.

Figure 1 Matrix of potential legal frameworks for a company and its stakeholders © Matti Engelberg



Further, schemes of arrangement are also used jointly with insolvency proceedings. Combining a pre-pack administration (where the court approves a transfer of assets and business of the debtor to a company owned by the creditors) with a scheme proceeding, this enables, economically, a completion of a debt-for-equity swap, even against the view of dissenting shareholders. However, this structural mechanism entitles the shareholders to retain the shares. Though the court's acceptance of a transfer of the debtor's business and assets to a company owned by creditors constitutes, in economic

9 Matti Engelberg, the proposed EU framework for preventive restructuring and the English schemes of arrangement regime—seeking the best *Preventive* model for each Member State *Capital Markets Law Journal*, Volume 14, Issue 2, April 2019 251–273

terms, a cross-class cram-down of the equity holders, the court process nevertheless aims to protect the interests of all stakeholders.

Most English public takeovers are conducted through a scheme process, as this is a faster and more predictable process than merely using a traditional takeover route. Particularly for distressed companies, the ability to combine features of both company and insolvency law in a transaction provides a high degree of flexibility. This flexibility is particularly important in large transactions. An example of such a transaction was the takeover by Royal Dutch Shell of the BG Group Plc in 2016. Valued at over $50 billion, this transaction was completed in only 55 days and resulted in the friendly bidder acquiring 100 per cent ownership of the target.

3. Unjustified Holdouts

Professor Stephan Madaus describes a holdout creditor or equity holder as:

> *'[a] person of such class of stakeholders who has voted to reject the restructuring plan while a majority of fellow creditors or equity holders, in his class or in other classes, voted to accept it. Holdout stakeholders are those who could not convince the others to reject the plan. They hold a minority position and stick with it, when facing the result of the voting process. Thus, they oppose the decision of the 'maior et sanior pars'.'*[10]

Abuse of holdout positions may have a detrimental effect on any restructuring process. The recent dissertation of the co-author analysed the changeover of the markets for corporate financing after the 2008 financial crisis, particularly the diversification of financing sources, and the consequential need to develop new frameworks for preventive restructuring.

Diversified company balance sheets augment the need to develop tools for preventive restructuring. Due to the financial diversification of a balance sheet, a dissenting small holder of equity or debt instruments of a company may constitute an obstacle to a proposed restructuring, in that they may have a strong holdout position. A company law scheme of arrangement framework could operate as a legal tool to protect companies and their key stakeholders against the abuse of such holdout positions.

4. Cross-Class Cram-Down

A group of highly-regarded experts working for the European Commission developed the content of the draft for the Restructuring Directive, originally published in 2016. The final version of the Directive contains modified sections relating to the so called cross-class cram-down mechanism and a new section for a relative priority rule, substantially based on the work of this CODIRE-group.[11] Hence, the provisions relating to cross-class cram-down and the relative vs. absolute priority rules are also interrelated.

Cross-class cram-down refers to a mechanism whereby a restructuring plan is accepted by a court notwithstanding disagreement by a majority of a voting class. According to the Directive, for the plan to be confirmed in the case of a cross-class cram-down, it should be supported by a majority of voting classes of affected parties. At least one of those classes should be a secured creditor class or senior to the ordinary unsecured creditors class.[12]

10 Stephan Madaus, Leaving the Shadows of US Bankruptcy Law: A Proposal to Divide the Realms of Insolvency and Restucturing Law, Eur Bus Org Law Rev (2018) 19, 636

11 Codire BEST PRACTICES IN EUROPEAN RESTRUCTURING, Contractualised Distress Resolution in the Light of the Draft Directive proposal of 22 November, 2016, 5.7.2018, Conference outline and programme, available at: <https://www.codire.eu/event/best-practices-in-european-restructuringcontractualised-distress-resolution-in-the-light-of-the-directive-proposal-of-22-november-2016/>

12 Restructuring Directive, recital 53

As stated in the recitals to the Directive, where equity holders have the right to vote on a restructuring plan, a judicial or administrative authority should be able to confirm the plan by applying the rules on cross-class cram-down, notwithstanding the dissent of one or more classes of equity holders. Member States that exclude equity holders from voting should not be required to apply the absolute priority rule in the relationship between creditors and equity holders. Another possible means of ensuring that equity holders do not unreasonably prevent the adoption of restructuring plans would be to ensure that restructuring measures that directly affect equity holders' rights, and that need to be approved by a general meeting of shareholders under company law, are not subject to unreasonably high majority requirements and that equity holders have no competence in terms of restructuring measures that do not directly affect their rights.[13]

The possibility for direct mandatory cross-class cram-down of equity is not included in the restructuring frameworks of any Nordic country, for example. To analyse the feasibility of such a regime, the Finnish government has completed a recent comparative survey of debt-for-equity swaps, by comparing practices in eight jurisdictions.

In international legal writing, debt-to-equity conversion is defined as an instrument used in corporate restructuring where the creditors of a debtor company swap for, or convert certain debtor company debt into, the debtor company's shares or share capital. This conversion can be conducted in several different ways depending on the relevant country's legal system, but the swap or conversion will always result in the complete cessation of, or a partial reduction in, the amount of unpaid debt. An evaluation of how national legislation governs corporate restructuring and corporate arrangements was conducted as part of the Finnish governmental study for purposes of determining possible revisions. This evaluation required a comprehensive comparison of provisions governing company law, insolvency law and other corporate arrangement laws in certain relevant countries. The countries selected for review were Sweden, Denmark, the United Kingdom, the United States of America, the Netherlands, Germany, France and Switzerland. The research methods used to conduct the review were collecting and reviewing written studies provided by expert organisations located in the compared countries; conducting research on the relevant legislation, legal literature and case law; arranging interviews with relevant experts; and conducting a comparative law study.[14]

5. Relative Priority Rule

The CODIRE Expert Group outlines the merits of the relative priority against absolute priority as follows:

> *'However, when looking at a going concern business and at a negotiated and voted-on restructuring solution, this rigidity of the absolute priority rule can become problematic. On the one hand, it may make particularly difficult restructuring based on plans with more than one class of creditors (which are instead valuable because*

13 Restructuring Directive, recital 57

14 J. Tähtinen – R. Peldán – J. Dammert, An international study on debt-to-equity conversion in connection with corporate arrangements and insolvency, Publications of the Government's analysis, assessment and research activities 6/2018, available at: <https://tietokayttoon.fi/julkaisu?pubid=24204> The study (which, unfortunately for international usage, is in Finnish) contains a useful comparative table with information on the Finnish position, compared with the eight other jurisdictions that are covered in the study. This table would be a good tool for any legislator wishing to understand further the variation between the respective systems. The co-author is aiming to contribute a translation of the table for those who may have a further interest in this.

they allow creditors to vote according to their economic interests). On the other hand, the APR may impede or even condemn, in particular, any attempt to let the current shareholders retain a stake in the restructured business.

The latter concern is of special importance with owner-run/family-run businesses and thus with MSMEs; it is often desirable, though, to incentivise the shareholders/managers to restructure early, to discourage them from holding out of an agreement, to contribute and commit to the restructuring and to apply their knowledge of the business in the interest of the creditors throughout and after restructuring. We have heard evidence of this from several jurisdictions. We are not alone in highlighting these considerations. The American Bankruptcy Institute's report on Chapter 11 reform (2014) devotes a lot of attention to easing the absolute priority rule in different ways (including a specific and very sophisticated approach for MSMEs, see pp. 299-302 of the report, Chapter VII. »Proposed Recommendations: Small and Medium-Sized Enterprise (SME) Cases).

Taking into account the role that business owners of MSMEs, in particular, may be expected to play in the restructuring, the absolute priority rule may even fall short of the fairness it is supposed to ensure for distributions in the first place; we advocate, thus, for a more flexible standard allowing distributions to junior classes (or their retention of interests and economic values) even before all (dissenting) senior classes are satisfied in full.'[15]

In the US, for Chapter 11 of the Bankruptcy Code, the absolute priority rule has been a common starting place. However, even in the US, the development has been towards a hybrid system of priority that may be more efficient than one centered around absolute priority.[16]

Professor Douglas Baird outlines key reasons for the development:

> *'To decide who gets what under absolute priority in the absence of a sale, the judge must determine the value of the firm. The empirical evidence does suggest that, in large reorganizations, judicial valuations are unbiased, but these unbiased valuations are made with high variance. Even if bankruptcy valuations could be improved, a major problem remains: 'All estimates of value are noisy.' Coming within ten percent of the true value of the firm merits high praise even when the best experts do it.'*[17]

Relative priority should be, according to the authors, understood merely as a developed deviation of the absolute priority rule, which would bring along more flexibility for the respective insolvency administrator for preparing the restructuring programme and for the court for judging about this. However, even the new relative priority principle, included as a principal option in the Directive, has also been subject to criticism by e.g. the Dutch professors de Weijs, Jonkers andMalakotipour:

> *'Next to upending the basic fabric of private law, EU RPR disregards that the company to be reorganized did not end up in that state by coincidence. Allowing shareholders to retain shares whilst writing down creditors against their majority vote would not only add insult to injury for creditors, but would also provide a further subsidy to shareholders that incentivizes to over-*

15 Contractualised Distress Resolution in the Shadow of the Law, expert group funded by the EU; Comments to the Proposal for Directive, draft of 25th June, 2018, 3-6, available at: <www.codire.eu>

16 Douglas G.Baird, Priority matters: Absolute Priority, Relative Priority and the Costs of Bankruptcy, University of Pensylvania Law review, Vol 165, March 2017, No 4 785-786

17 Idem 785-786

leverage companies, leading to instability in the economy.' [18]

As a comment to this critique, it is appropriate to note the counter arguments from Professor Bob Wessels:

'De Weijs et al fail to appreciate that a debtor (a business) under the proposed Directive is not insolvent. This follows directly from Article 1(a), stating that '[t]his Directive lays down rules on: preventive restructuring frameworks available for debtors in financial difficulty when there is a likelihood of insolvency [my italics] with a view to preventing the insolvency and ensuring the viability of the debtor.' This is why applying the logic and rules of insolvency law, including the APR, is not justified. In the absence of insolvency, the arguments for changing the capital structure of the debtor (e.g. by wiping out shareholders and (as the case may be) junior creditors) are unconvincing.

Although I understand the criticism by professor De Weijs et al, in the gamut of proposed rules and tools, the RPR is seen and analysed as one isolated aspect. The authors are rather silent on the possibility that the RPR will create incentives for early restructuring. In case of the application of the stern APR, the debtor's company shareholders have very limited incentives to pursue restructuring as their equity will be fully wiped out. One of the major thrusts behind the proposed Directive is to ' ... enable the debtors to restructure effectively at an early stage'. Since the introduction of the APR as the single option disincentivises the debtor's directors and shareholders to use preventive restructuring frameworks, it may hamper the early restructuring of viable debtors in financial difficulties.' [19]

Thus, European legislators should thoroughly understand the complex nature of the issue. The debt-to-equity conversion appears at the crossroads of company and insolvency law. When a company is economically healthy, but has difficulties with financing, the toolbox both of an independent professional restructuring administrator, and of the relevant court monitoring the restructuring, should preferably be equipped with reasonably flexible tools.

In the Directive the key principles of the relative priority rule are set out at Article 11:

…

'(c) it ensures that dissenting voting classes of affected creditors are treated at least as favourably as any other class of the same rank and more favourably than any junior class; and

(d) no class of affected parties can, under the restructuring plan, receive or keep more than the full amount of its claims or interests.'

But the Member States are still entitled to use the absolute priority as an option:

…

'By way of derogation from point (c) of paragraph 1, Member States may provide that the claims of affected creditors in a dissenting voting class are satisfied in full by the same or equivalent means where a more junior class is to receive any payment or keep any interest under the restructuring plan.' [20]

18 de Weijs, R.J., Jonkers, A.L., Malakotipour, M. 'The Imminent Distortion of European Insolvency Law: How the European Union Erodes the Basic Fabric of Private Law by Allowing 'Relative Priority', Amsterdam Law School Legal Studies Research Paper No. 2019-10

19 Wessels, Bob, A reply to professor De Weijs et al. 22.3.2019, available at: <www.bobwessels.nl>

20 Restructuring Directive, Article 11

The decision between relative and absolute priority is one of the key areas that Member State legislators should address when implementing the Directive. Therefore, they should preferably engage in a constructive dialogue with, and receive helpful guidance from, the Directorate of the EU Commission in respect of these legislative options.

6. Valuation, valuation, valuation ...

It is important to note the fundamental difference between a preventive restructuring and a comprehensive restructuring of a company. For preventive restructuring, the key focus relates to the ability to bind a dissenting minority creditor (or minority equity holder) to a compromise or arrangement proposed or supported by the company.

For a comprehensive restructuring of a company, it is common also to cover issues relating to the so-called 'division of the pie' among different classes of debt and equity. For this, the valuation of the company is critical. In order to determine how much each class should be entitled to receive under a plan, a proper valuation is the cornerstone of the process.

Beveridge *et al*. have outlined the factors for a distressed company, which may have a substantial impact on the value of the company. These include, *inter alia*, weakening credit terms, shortage of working capital, higher financing costs, valuation of balance sheet items based on a fire sale, high consulting costs, inability of the management to deal with long term issues, missing investment capacity and conflicts among the key stakeholders of the company.[21] This supports the experienced view of Professor Baird, that a valuation of a distressed company is always 'noisy'.

For the scheme of arrangement framework, the starting point is that the intended arrangement should have the support of a clear majority of each class, on whose position the intended arrangement has any impact. Hence, this should not have any valuation correlation. Thus, valuation may also be involved, indirectly, in a scheme process.

Jennifer Payne has outlined the possibility of combining a scheme process with a pre-pack administration in order to achieve, in effect, a cram-down of junior creditors or equity holders:

> *'Schemes alone cannot at present achieve the cramdown of junior creditors (or holders of equity, note by M.E.) within a company. It appears that, while cramdown within a class is possible, cramdown across classes is not, i.e. it is not possible to implement a scheme in circumstances in which a whole class of creditors (such as the junior creditors) votes against the scheme. Despite the decision in Re Tea Corporation Ltd, in which the ordinary shareholders voted against the schemes, but had their dissent disregarded at the sanctioning stage, on the basis that they had no economic interest in the company's assets, the view taken by the courts today is that the court does not have power to sanction a scheme where that scheme has not been approved by a class of the members or creditors.' ...*
>
> *'As a result, these restructuring arrangements have been implemented by way of scheme twinned with a pre-pack administration, in order to effectively reach the same result as the cramdown of a whole class.'*[22]

As a standalone process, a scheme of arrangement should address the voting of all classes and respect the majorities of such voting. Nevertheless, due to the fact that it is up to the

21 A. Beveridge, P. Hemming, G. Smith, Valuation of distress businesses, Strategies for Maximising Value, Ben Larkin,Globe Business Publishing Ltd, 2008 79

22 Jennifer Payne, Schemes of Arrangement, Theory, Structure and Operation, Cambridge University Press 2014 240-242

company to assess the parties to be called to the scheme consultation, the court may accept, in connection with related insolvency proceedings, the implementation of the restructuring, notwithstanding a dissenting majority of a class of junior creditors or shareholders.

7. Options for Implementing the Restructuring Directive

The Restructuring Directive is drafted from an insolvency law point of view. However, it covers issues which are customarily viewed as company law topics. As noted, the Directive even rules that the Member States should be able to derogate from the requirements laid down in Directive (EU) 2017/1132 of the European Parliament and of the Council (21) concerning the obligations to convene a general meeting and to offer shares to existing shareholders on a pre-emptive basis, to the extent and for the period necessary to ensure that shareholders do not frustrate restructuring efforts by abusing their rights under that Directive. It states further that the Directive (EU) 2017/1132 should be amended accordingly.

For the implementation of the Directive, it is important to understand that it only lays down the set objectives for minimum harmonisation and provides flexibility for the Member States for its implementation. Recital 16 of the Directive emphasises that '*Member States should be able to maintain or introduce in their national legal systems preventive restructuring frameworks other than those provided for by this Directive*'. Such a framework can also be a company law framework.

Further, Recital 29 of the Directive states:

> *'[w]here this Directive is implemented by means of more than one procedure within a restructuring framework, the debtor should have access to all rights and safeguards provided for by this Directive with the aim of achieving an effective restructuring.'*

Thus, a Member State may have several different frameworks for restructuring, provided that the minimum harmonisation requirements are fulfilled. France, Spain, Italy and UK, *inter alias*, already have several operative regimes.

Hence, the implementation of the Directive can be conducted in different ways, depending on the pre-existing frameworks in the respective Member State. As an example, all Nordic countries have existing regimes for restructuring already in place. These do not, however, include a possibility for the standalone 'workout' of a single credit facility.

An alternative for implementation would be to adjust the current restructuring regime to include a possibility for a single credit workout, without involving other creditors of the relevant company to the extent that their positions are unaltered, and to tackle the above-mentioned issues relating to debt-to-equity conversions under the same framework. A recent government proposal for new legislation in the Netherlands would serve as a good benchmark for this.

The second alternative, favored by the authors, is to consider a new scheme of arrangement framework based on the European Model Company Act (the 'EMCA') to cover the key areas of the preventive restructuring, whilst also providing sensible company law tools relating to cross-class cram-down of equity in connection with a related insolvency proceeding.[23] The EMCA was created by leading corporate law scholars, who made a decision, based on reasoned analyses, to include a section for a scheme of arrangement in the model companies act.

In any case, the position of shareholders in a restructuring, particularly the availability of a cross-class cram-down mechanism and the decision between optional methodologies – i.e. between relative or absolute priority – in the case

23 Andersen, Paul K. – Andersson, Jan B. edit. European Model Companies Act First edition, 2017, NORDIC & EUROPEAN COMPANY LAW LSN Research Paper Series, No. 16-26.

of dissenting classes, gives rise to the need for further analysis of potential changes to current regimes.

8. Constitutional Law and the Market Value Guarantee

Professor Stephan Madaus has outlined the main constitutional law issues relating to preventive restructuring arrangements. He refers to a market value guarantee under constitutional law:

> *'Moreover, constitutional law guarantees may limit the right to impose a contract (or plan). The right to property is protected in many constitutions and usually covers the possession of claims and shares. Any impairment without consent usually requires a general interest in the impairment, due process and a compensation. In such a setting, any impairment of a claim of a holdout creditor or of shares of an equity holder would require the involvement of a court. The latter would need to check whether the plan serves the general interest-usually the macroeconomic purposes shown above (debt cancellation and prevention of underuse). The court would also review whether all parties were treated fairly in the process (timely informed and asked to vote) and whether any impairment requires compensation. While no compensation is necessary as long as the plan only reduces a claim or share from its nominal to its current market value, any further impairment must be compensated. This constitutional law background led the common approach to compare the value of the firm in a no-plan scenario with the value of the firm in the plan scenario – the 'best interest test' or 'no creditor worse off principle.'*[24]

Addressing constitutional law issues in relation to the scheme of arrangement framework is not a simple task. As an analogy for this analysis, the co-author discussed the Finnish view on the abuse of law in his dissertation. In Finnish legal practice and literature, it has been noted that the standing on the abuse of law is negative; fully legal rights have been considered able to be restricted through a court judgment, in the event that the legal rights of a third party would have been jeopardised through such abuse.

As a constitutional normative justification, the co-author uses for guidance the narrative repeated by the English courts in scheme of arrangement rulings. English law requires that the sanctioned arrangement is such that an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve it. It further requires that the statutory majority is acting *bona fide* and is not coercing the minority in order to promote interests adverse to those of the class whom they purport to represent.[25]

From a constitutional law point of view, it should be noted that a scheme of arrangement mechanism in company law would merely form a framework, under which a court would make a judgment in each specific case, taking into account the normative grounds of the respective law, including constitutional law.

9. Who Owns the Equity?

When considering writing this article, the authors noted the importance of addressing a particularly polemic question, namely; who owns a company's equity? A company restructuring is always made in the shadow of a bankruptcy, under a risk that the holders of the company equity can lose their ownership. Customarily, in a bankruptcy, creditors also suffer substantially, as the value of the company may normally be clearly higher as a going concern.

24 Stephan Madaus Leaving the Shadows of US Bankruptcy Law: A Proposal to Divide the Realms of Insolvency and Restucturing Law, Eur Bus Org Law Rev (2018) 19, 636

25 Jennifer Payne, Schemes of Arrangement Theory, Structure and Operation, Cambridge University Press, 2014 73

Under any accounting rules, it is evident that all funds invested in a company, whether in the form of equity or debt, constitute assets of the company. Nevertheless, the agency relationship in corporate law between shareholders on one hand, and creditors on the other, is a key point for legislators to understand. Hansmann and Kraakman outline this through examples:

> *'To take a conspicuous example in the corporate context, rules of law that protect creditors from opportunistic behavior on the part of corporations should reduce the interest rate that corporations must pay for credit, thus benefiting corporations as well as creditors. Likewise, legal constraints on the ability of controlling shareholders to expropriate minority shareholders should reduce the cost of outside equity capital for corporations. And rules of law that inhibit insider trading by corporate managers should increase the compensation that shareholders are willing to offer the managers. In general, reducing agency costs is in the interests of all parties to a transaction, principals and agents alike.'* [26]

Due to the factors mentioned in Section 6, the valuation of a distressed company is 'noisy'. Prior to insolvency, the environment of a distressed company is challenging – it is a particularly difficult area not only for a court to judge, but also for legislators to regulate. Still, it is important to note, as a principle, that the equity of the company may be finally, but not ultimately, owned by the shareholders – who would have at any stage a collective right to liquidate the firm and to receive back the remaining funds put into the firm as equity. This right is the basis of their direct asset – shares in the company. Therefore, under company law principles, the shareholders are, until insolvency, entitled to decide on issues involving their assets – shares of ownership of the company.

At the crossroads of company and insolvency law, a legislator should therefore address both of these areas of law.

Understandably, in proceedings based on insolvency law, one may consider that it is *prima facie* possible to override certain aspects of company law. However, at least for the clarity of the two areas of law, sufficient regard should nevertheless be had to issues of company law when operating in the insolvency law sphere, and *vice versa*.

Assuming that the restructuring laws of a country permit a debt-for-equity swap, the way that the swap is achieved should also be considered from a company law point of view. How the new shares should be issued, who should decide the proper issue price on which the relevant debt should be converted into share capital and how different classes of shares should be treated are examples of company law questions that may arise. To the extent that any converted debt entitles a debtor to a position of control over the company, minority protections for existing equity holders under company law may also play a role.

As a benchmark for this regulation, the authors see merit in the English law dual-process system, where a process may begin as a standalone preventive restructuring ruled under company law, but under which it is also able to combine, if needed, a company law scheme of arrangement with an insolvency law administration process. In such a dual-process model, the rights of shareholders arising under company law would be duly considered.

10. Conclusion – options for legislators

To conclude, the benefits of schemes of arrangement have been widely recognised; leading European corporate law professionals have addressed their potential benefits, and provisions on schemes of arrangement have been included in the model act EMCA.

26 H.Hansmann – R.Kraakman Agency Problems and Legal Strategies Yale Law School Center for Law, Economics and Public Policy Research Paper No. 301 2004

Incorporating the scheme of arrangement regime in the Member States would, *de minimis*, provide legal protection for a clear majority of holders of a debt or equity instrument against the dissentient minority of the same class, in circumstances where the minority may be considered to be acting against the joint economic interest of the respective instrument.

The new Restructuring Directive calls for early-stage preventive frameworks, which allow workout -type transactions, involving creditors only of a single credit facility. Based on the current regimes *inter alia* in the Nordic countries, this is not currently an option – the only alternative is to enter into a full restructuring involving all of the creditors of the company.

Given that the recent trend of diversification in financing is providing further possibilities for opportunistic market players to utilise aggressively their minority holdout rights in different financial instruments, the protections provided by the scheme of arrangement framework are becoming increasingly important. In various jurisdictions, therefore, the introduction of scheme of arrangement provisions would diminish the opportunities available to activist funds.

By being as prompt and smart as these activist funds, European legislators could create a more stable and predictable environment for businesses. When seeking the best future model for implementing the Directive, it is highly important to understand the various systemic options for regulating this essential area for corporates, which is customarily defined as *preventive* restructuring.[27]

27 Matti Engelberg, the proposed EU framework for preventive restructuring and the English schemes of arrangement regime—seeking the best *Preventive* model for each Member State *Capital Markets Law Journal*, Volume 14, Issue 2, April 2019 273